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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 675

THE DETROIT EDISON COMPANY,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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BRIEF ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

This case comes up on a writ of certiorari granted March 1, 1943 (R. 55) to review the judgment (R. 47) of the United States Circuit Court of Appeals for the Sixth Circuit affirming the decision (R. 42) of the United States Board of Tax Appeals (now The Tax Court of the United States) in the above entitled proceeding.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 47-54) is reported in 131 F. (2d) 619. The opinion of the Board of Tax Appeals (R. 38-42) is reported in 45 B. T. A. 358.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered November 30, 1942. Jurisdic-

tion is found in the provisions of Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTE INVOLVED

The statute involved is the Revenue Act of 1936, Ch. 690, 49 Stat. 1648, the pertinent provisions of which are set forth in the Appendix.

QUESTION PRESENTED

Is the basis for depreciation for Federal income tax purposes of depreciable business property that is constructed by the owner to be changed by the fact that the owner receives a cash payment from a non-stockholder as a condition precedent to the construction and operation of such property,—the owner upon such construction being required by law indefinitely to maintain the property and furnish electric energy upon demand at regular rates to the non-stockholder and others adjacent to the property? Is the depreciation basis (a) the actual cost of construction or (b) the cost of construction reduced on account of the payment received from the non-stockholder?

STATEMENT

Petitioner is a public utility corporation of New York, licensed to do business in Michigan, and is engaged in generating and selling electric energy in the City of Detroit and surrounding territory and operates under the jurisdiction of the Michigan Public Service Commission (R. 15-16).

Petitioner, in connection with the distribution and sale of electric energy, from time to time receives applications for extension of its transmission and/or distribution lines to places which, in petitioner's opinion, are situated too far

from its existing lines to warrant the expenditure of the amounts necessary to make such extensions. In such situations, two alternative procedures are in general available to an applicant. He may either build the desired extension himself and then turn it over to the petitioner, or if he chooses he may pay the petitioner a sum of money whereupon the petitioner will build the extension. These alternative procedures are specified in the petitioner's rules, filed with the Michigan Public Service Commission and printed on the reverse side of the regular line extension agreements (R. 24, 27), and the accounting is done under the regulations of the Commission. We here have to deal only with a situation where the second alternative is adopted, but it is well to note the existence of both alternatives for, as we shall point out hereinafter, the tax consequences ought to be the same regardless of the alternative adopted.

Where, as here, the applicant selects the second alternative, petitioner, as a condition precedent to the construction of the desired extension, requires the applicant to pay to it a sum representing the estimated cost per mile for construction of such extension, which payment is agreed to in writing (R. 16). The amount paid by each applicant, which never exceeds the actual cost of construction, is final as to such applicant regardless of the actual cost of construction, except that under his contract he may become entitled to a refund upon the happening of certain events (R. 16, 18-19).

The agreement between the petitioner and each applicant is evidenced by one of five standard types of contract (R. 16, 21-37). Under contracts of the first four types, the applicant becomes entitled to receive during the first five years following completion of the extension a refund

of a sum up to but not exceeding the amount of his payment, computed in accordance with a formula depending for its operation upon either (1) the number of additional customers who subscribe for service over the particular line extension or (2) the gross revenue received from such line extension. Under contracts of the fifth type, the applicant is entitled to no refund.

The cash payments received from applicants are not earmarked in petitioner's accounts for the construction of line extensions, but the sums received become part of petitioner's free working capital and are carried in petitioner's accounts accordingly (R. 17).

Material and labor used in the construction of the line extensions are paid from the general working funds of the petitioner and it makes in its books of accounts entries identifying all work performed under the provisions of each respective contract (R. 16).

Upon completion of a line extension, petitioner in accordance with standard practice enters upon its books as a property item the cost of the line extension including labor and material and does not subtract from that sum the amount of the payment made by the applicant (R. 17).

Petitioner's accounting procedure is in accordance with the Uniform Classification of Accounts for Electric Utilities prescribed by the Michigan Public Service Commission (R. 17-18). This procedure is as follows: Upon receipt of a payment from an applicant, petitioner debits its cash account and credits one of the special accounts referred to below with the amount thereof. In the case of payments subject to possible refund, the payments are credited to a special account entitled "Customers Deposits for

Line Extensions", classified under account No. 261 entitled "Miscellaneous Unadjusted Credits"; and upon the expiration of the period for refund any unrefunded balance is transferred from account No. 261 to special account No. 255 entitled "Contributions for Extensions". In the case of payments not subject to refund, the payments are credited in the first instance to account No. 255. Upon construction of a line extension, petitioner credits its cash account and correspondingly debits its property account. Depreciation on the line extension is currently credited to depreciation reserve and debited to depreciation, which is an operating expense entering into profit and loss account. Upon retirement of a line extension, depreciation reserve is debited and the property account credited. No adjustment is made to special accounts Nos. 261 or 255 in connection with the construction, depreciation or retirement of a line extension.[1]

After completion of a line extension, petitioner is under a legal duty, at its own expense, to keep and maintain the line extension in good repair and working order, and to replace the same in whole or in part as and when necessary, so that service will at all times be available therefrom (R. 20).

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[1] The Court and the Board erroneously assumed that when the period for refund expires all remaining balances in these accounts are credited to Surplus. Transfers to Surplus were in fact made only in 1932, 1933 and 1934 (R. 19). These transfers were approved by the Michigan Public Service Commission on the understanding that for rate making purposes the amounts transferred would be included in income for the years in which the payments were received. *Re The Detroit Edison Co.*, 16 P.U.R. (N.S.) 59 (Michigan, 1936).

During the years 1936 and 1937, applicants' payments in the amounts of $36,065.81 and $47,500.67, respectively, were received subject to no refund or became unrefundable by virtue of the expiration of the period for refund. Petitioner did not report these amounts as income and respondent did not attempt to subject them to Federal income tax (R. 20).

In its returns for 1936 and 1937, petitioner claimed depreciation deductions at approved rates upon its line extensions at their cost of construction as shown by its books, without any reduction for amounts paid by applicants. Respondent disallowed a portion of such depreciation deductions on the ground that the basis upon which depreciation is to be calculated is the amount expended in construction of the line extensions diminished by the total amount paid by applicants under contracts providing for no refunds, and by the mean between the beginning and end of each year of the unrefunded balances of amounts paid by applicants under contracts providing for refunds and with respect to which the period for refund had expired (R. 9-10, 20-21). He used this formula irrespective of whether the particular line extensions in respect of which the payments were made were still in existence.

The amount of depreciation deductions in dispute is $40,273.11 for the year 1936 and $41,786.26 for the year 1937 (R. 21).

The Board of Tax Appeals sustained the respondent (R. 42), and on appeal the Circuit Court of Appeals for the Sixth Circuit affirmed (R. 47).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the funds utilized by petitioner in constructing its line extensions can be traced and that their source is material in determining the cost to petitioner and its basis for depreciation of the line extensions.

2. In holding that payments received by petitioner from prospective customers upon applications for construction of line extensions constituted "receipts" to be deducted under Section 113(b)(1)(A) of the Revenue Act of 1936 in determining petitioner's cost and basis for depreciation of its line extensions; and in failing to hold that such payments, if their status was material, constituted contributions to capital within the meaning of Section 113(a)(8)(B), or gifts within the meaning of Section 113(a)(2), or consideration received for obligations of equal value assumed, as would clearly have been the case if the line extensions had been built by the applicants and then turned over to petitioner as petitioner's rules permitted.

3. In holding that there was consideration for the contributions so as to prevent them from being gifts and then failing to follow through consistently by giving effect to the value of such consideration as the purchase price.

4. In holding that capital contributions can be made only by shareholders, and in thus disregarding the express provision of Article 113(a)(8)-1 of Regulations 94 that property may be received by a corporation "from any person as a contribution to capital".

5. In holding that capital contributions cannot be made for a specific purpose.

6. In holding that petitioner's basis for depreciation and its depreciation deductions for 1936 and 1937 in respect of line extensions constructed and owned by it and used in its business should be reduced on account of payments made to it by prospective customers on applications for construction of line extensions.

7. In affirming the decision of the United States Board of Tax Appeals.

SUMMARY OF ARGUMENT

1. The line extensions in question are property (a) constructed and owned by the petitioner, (b) used by it in the conduct of its business and (c) with a limited useful life. These facts are admitted, and the petitioner is therefore entitled to depreciation allowances under the provisions of the governing revenue act, the only remaining factor being the proper depreciation basis.

2. In determining petitioner's cost of the line extensions, the Board and the Circuit Court of Appeals sought to look to the source of the funds utilized in their construction, thereby adopting a criterion that is unsound and wholly irrelevant. The funds used in constructing the line extensions cannot be traced; but even if traceable, the source of the construction funds is wholly immaterial in determining the cost of the extensions under the generally accepted and administratively essential income tax rule. The amount expended establishes the cost, whether the funds came from original capital, earnings, borrowings, contributions to capital, gifts or any other source.

3. The controlling rule must be found in the statute. Necessarily the petitioner gave a consideration for the line extensions or it gave no consideration; there is no possible middle ground. If it gave a consideration, the amount or value of that consideration is its cost and basis for depreciation. If it gave no consideration on the theory that the extensions were in effect contributed by prospective customers, it must necessarily have acquired them as gifts or as contributions to capital in which event under the statute its depreciation basis would be the transferors' cost. On either premise, the petitioner's basis for depreciating the line extensions is the same—the amount expended on their construction.

4. The Court below, prior to this Court's decision of March 1, 1943 in *Helvering* v. *American Dental Co.*, said the contributions were not gifts because there was consideration for them, but it failed to follow through consistently. For if the contributions were acquired for a consideration they were bought; they could not be "receipts" properly chargeable to capital account under Section 113(b)(1)(A), as held below, any more than they could be gifts.

5. The correct view is that the cash contributions increased capital account, and when expended on the line extensions served to increase the basis thereof, to exactly the same extent as if there had been a contr bution of the property itself, as petitioner's rules permitted. If an applicant builds a line extension and then contributes it to petitioner in lieu of cash, the contribution cannot reduce the basis of any of petitioner's property by adjustment of the unadjusted basis under Section 113(b)(1)(A). Obviously, the basis for petitioner's other property would not be

affected. A single property contribution cannot create a basis and an adjustment of it as well. This demonstrates the Court's error in applying the cash contributions in reduction of basis of the line extensions under Section 113(b)(1)(A), for contributions in cash and in property for identical purposes must necessarily be treated similarly.

6. The Board of Tax Appeals was obviously influenced, and the Circuit Court of Appeals may have been, by an assumption that if the claimed depreciation were allowed the petitioner would obtain an undue or double benefit. Actually petitioner would obtain no such benefit, indeed no benefit at all. But even if it did, the question of double benefit, like double taxation, lies with Congress; and the petitioner, the Commissioner and the Courts must take the statute as they find it and may not read into it something which is not only not there but which is in fact inconsistent with its terms.

ARGUMENT

I

PETITIONER'S COST OF THE LINE EXTENSIONS IS THE AMOUNT EXPENDED ON THEIR CONSTRUCTION AND THAT AMOUNT IS THE BASIS FOR DEPRECIATION THEREOF UNDER THE STATUTE. THE CONSTRUCTION FUNDS ARE NOT TRACEABLE AND EVEN IF THEY ARE THEIR SOURCE IS IMMATERIAL.

Money and property contributions and subsidies to corporations from third parties for specific purposes in the mutual interests of all concerned are not uncommon. That such contributions and subsidies are not taxable as income has been settled by this Court in *Edwards* v. *Cuba*

Railroad Co., 268 U. S. 628 (1925), which has been uniformly followed in a long line of cases.[2] The equally important question as to the effect of such cash contributions upon the basis for depreciation of the property constructed therewith, and as to the basis for depreciation of property directly contributed, is now presented to this Court in order to settle a conflict in the decisions below.

For Federal income tax purposes, depreciation deductions on the full cost of line extensions constructed with the aid of such contributions were once allowed without question and only the taxability of the payments was disputed. *Tampa Electric Co.*, 12 B. T. A. 1002; *Frank Holton & Co.*, 10 B. T. A. 1317. Indeed, the leading cases involving the nontaxability of subsidies and consumers' contributions expressly pointed out that cost of construction and plant account were not reduced by the amounts

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[2] These cases include the following: (a) Electric Utilities: *Liberty Light & Power Co.*, 4 B.T.A. 155; *Rio Electric Co.*, 9 B.T.A. 1332; *Wisconsin Hydro-Electric Co.*, 10 B.T.A. 933; *Tampa Electric Co.*, 12 B.T.A. 1002. (b) Others: *Great Northern Railway Co.*, 8 B.T.A. 225, 271, petition to review dismissed 40 F. (2d) 372 (C.C.A. 8th); *Aransas Compress Co.*, 8 B.T.A. 155; *Texas & Pacific Railway Co.*, 9 B.T.A. 365, *Atlantic Coast Line Railroad Co.*, 9 B.T.A. 1193; *El Paso Electric Railway Co.*, 10 B.T.A. 79; *Frank Holton & Co.*, 10 B.T.A. 1317; *Kauai Railway Co.*, 13 B.T.A. 686; *Kansas City Southern Railway Co.*, 16 B.T.A. 665, 687, appealed on other points 52 F. (2d) 372 (C.C.A. 8th); *Midland Valley Railroad Co.*, 19 B.T.A. 423, appealed on other points 57 F. (2d) 1042 (C.C.A. 10th); *Union Pacific Railroad Co.*, 26 B.T.A. 1126, appealed on other points 69 F. (2d) 67, 69 F. (2d) 966 (C.C.A. 2d), 293 U. S. 282; *Southern Railway Co.*, 27 B.T.A. 673, appealed on other points 74 F. (2d) 887, 80 F. (2d) 884 (C.C.A. 4th); *Baltimore & Ohio Railroad Co.*, 30 B.T.A. 194; *Valley Waste Disposal Co.*, 38 B.T.A. 452; *Decatur Water Supply Co.* v. *Commissioner*, 88 F. (2d) 341 (C.C.A. 7th); *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. (2d) 762 (C.C.A. 4th).

received. *Edwards* v. *Cuba Railroad Co., supra; Liberty Light & Power Co.*, 4 B. T. A. 155. In this case, however, the Circuit Court of Appeals and the Board, recognizing the long settled rule that the contributions did not constitute taxable income, thought with the Commissioner that the petitioner's cost of the line extensions should be reduced on account of the contributions and by differing reasoning reached that result.

Section 23 (1) of the Revenue Act of 1936, which governs the years in question, and Article 23 (1) of Regulations 94 promulgated under that Act, specifically authorize depreciation allowances in respect of property (a) owned by the taxpayer, (b) used in its business and (c) having a limited useful life. These criteria are admittedly present here, and the only other factor is the basis on which the depreciation allowances are to be calculated.

The pertinent basis provisions of the 1936 Act are contained in Sections 113 and 114 of the Act, set forth in the Appendix. Under these provisions, the basis of property for the purpose of calculating depreciation allowances is the cost of such property, with certain exceptions not material to the discussion at this point but which will be referred to later.

(1)

The petitioner contends that the amount it expended on construction of the line extensions constitutes its cost of the extensions just as fully and effectively as if no contributions had been received from prospective customers.

It constructed the extensions with its own materials and labor, making the cash expenditure therefor from its general working funds; and it did so without regard to the

adequacy or inadequacy of the contributions. No specific use was made of the money contributed; it was not required to be, and was not, earmarked; it became a part of the petitioner's free working capital; it was deposited in the petitioner's general bank account and intermingled with its other funds; and it cannot be traced.

Even if the funds used by petitioner in constructing the line extensions were traceable, their source—whether from earnings, loans, capital contributions, gifts or otherwise—is wholly immaterial. There is no authority in the law for tracing funds in determining the cost of property; it is enough that the owner paid out its own money for it, however the money was obtained. The receipt and the payment out of corporate funds have always been considered separate and independent transactions under the tax laws, even though from an economic standpoint the one might not be possible without the other. If the rule were otherwise, an impossible complexity would be introduced into tax administration.

(2)

In holding that the petitioner's basis for depreciation of its line extensions was not the amount expended by it in their construction but was that amount less certain amounts contributed by prospective customers toward the cost of construction, the decision below is in direct conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. (2d) 762. This the Court below expressly recognized. In that case, Arundel-Brooks Concrete Corporation constructed for $40,000 a concrete mixing plant at Sparrows Point, Maryland, in order to supply

Bethlehem Steel Company with concrete necessary for new construction. Maryland Slag Company contributed $20,000 toward the construction cost, it being in its interest to do so since it had a contract with Bethlehem Steel Company to remove, process and market slag from the latter's blast furnaces at Sparrows Point and processed slag was used in making concrete. The Commissioner claimed that Arundel-Brooks Concrete Corporation had a cost and depreciation basis for the new plant of only $20,000 and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Fourth Circuit reversed the Board and held that the corporation's cost and basis for depreciation of the plant was the $40,000 actually expended in the building thereof and not that sum less the $20,000 contributed by Maryland Slag Company toward the cost of construction, since " 'cost' * * * would remain the same regardless of the source of the funds from which payment was made".

The decision below is also in conflict with the earlier decision of the Circuit Court of Appeals for the Sixth Circuit in *Nashville Warehouse & Elevator Corp.* v. *Commissioner*, 105 F. (2d) 883, a case which the Court below thought distinguishable but which the Circuit Court of Appeals for the Fourth Circuit in *Arundel-Brooks Concrete Corp.* v. *Commissioner* said was persuasively analogous. In *Nashville Warehouse & Elevator Corp.* v. *Commissioner*, the taxpayer purchased elevator property for $40,000 payable in installments and paid all but $12,733.67 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property by fire. The Commissioner contended that the cost of the property to the taxpayer was $12,733.67, not $40,000. But the Court answered this by saying: "Obviously the full item should

be included in figuring the cost of the property. Whatever the source of the funds from which payment was made, the cost was $40,000."

An analogous but unsuccessful attempt to trace funds was once made by the Commissioner when he sought to require different treatment of unamortized bond discount on bonds retired with the proceeds of a refunding issue than on bonds retired with funds from other sources. But his attempt thus to make the source of the retirement funds of tax consequence was uniformly defeated; and the point must now be regarded as settled. *Great Western Power Co. of California* v. *Commissioner*, 297 U. S. 543.

Here too it is wholly immaterial from what source the petitioner obtained the money with which to construct its line extensions. The receipt of the funds and the construction of the extensions are severable transactions, each standing on its own feet for tax purposes, however related they may be economically. The cost to the petitioner of the extensions, and the basis thereof for depreciation, is the amount it expended on their construction; and, in basing its decision essentially upon tracing and giving importance to the source of the money used by petitioner, the decision below is unsound.

(3)

The perplexity and uncertainty that would result from attempting to trace the funds used in construction are well illustrated by the facts in the present case. Under the terms of some though not all of the contracts, *i.e.*, those typified by Exhibits I to IV inclusive (R. 16, 18-19, 21-34), the petitioner is obligated to make refunds over a five-year period after completion of construction. The amounts of refunds during this period cannot be prophesied; they may or may

not equal, though they cannot exceed, the total of the applicants' contributions. The amounts of the refunds are measured by future events, namely, the number of additional customers who subscribe for electric service over the line extensions or the gross revenue derived by the petitioner therefrom during the five-year period. If the funds used by the petitioner are to be traced in determining cost, the depreciation basis might vary from day to day, for refund periods expire at differing times and, until the period has run, every time an applicant uses power, and every time a new customer subscribes for service or is supplied from a line extension, an obligation to make a refund might accrue.

The Commissioner arbitrarily took annual balances of the payments made by applicants that were no longer refundable, and diminished petitioner's actual construction costs by the mean of those balances between the beginning and close of each of the years 1936 and 1937 (as well as by applicants' payments that were not refundable), allowing the remainder of the petitioner's costs irrespective of whether further refunds must be made. He was forced to adopt this arbitrary compromise position as an alternative to saying that line extensions constructed under refund contracts remain in a strange state of suspension taxwise during the first five years of their operation, with no depreciation allowable thereon during that period despite their exhaustible nature and their day-to-day use in the business.

The Court below recognized the illogical unsoundness of the Commissioner's position but reached a confusing and unsatisfactory conclusion. Holding that petitioner's cost of construction ought to be reduced by all applicants' contributions whether or not subject to refund on the ground that

they had "a direct relationship to cost", the Court mooted the question whether the portion of such contributions subsequently refunded should then be added back to cost as a capital expenditure or be treated as an ordinary business expense having no "reasonable relationship to the cost of a depreciable asset". The Court did not explain how payments of the same character could possibly fall within both of these two inconsistent categories, or how the mere refunding pursuant to agreement of a receipt not constituting income could possibly be a business expense. Likewise, it failed to comment on the obvious unfairness of denying depreciation on depreciable property during the first five years of its operation where the owner, refunding the applicants' entire contribution, bears the entire cost and actually suffers a current loss through wear and tear, or upon the practical impossibility of adjusting depreciation base from day to day as refunds are made or refund periods expire.

Moreover, the decision below would lead to this absurd result: assuming, for example, that the petitioner received $1000 from an applicant and constructed a line extension costing $1200 and that upon expiration of its useful life the petitioner replaced the extension at a cost of $1200 out of funds in its treasury, the decision below would require the original payment of $1000 still to be deducted, so that the petitioner would have a depreciation basis of only $200 although it actually expended $1200. The reason for this is that under the decision below, no matter what property is included in the petitioner's property account, unrefunded contributions theretofore made by applicants would have to be deducted in determining the depreciation basis even though the line extensions in respect of which the contri-

butions had been received had been replaced without requiring any further contributions from the applicants. Under the Uniform System of Accounts adopted by the Michigan Public Service Commission, the accounting procedure is as follows: When a payment is received from an applicant the petitioner's cash account is debited and a special account, No. 255 or No. 261, is credited. When a line extension is constructed the petitioner's cash account is credited and its property account is correspondingly debited. Current depreciation on the line extension is credited to depreciation reserve and debited to "Depreciation", which is an operating expense entering into profit and loss account. When the line extension is retired, the depreciation reserve is debited and the property account credited; no adjustment is made to accounts Nos. 255 or 261 by virtue of such retirement. Accordingly, if, in determining the depreciation basis for tax purposes at any given time, there is deducted from property account the unrefunded balance of the amounts credited to accounts Nos. 255 and 261, the result would be a depreciation basis having no relation to the line extensions then in existence that were constructed with the aid of applicants' contributions. In the course of time there would inevitably be a denial of depreciation basis for property on hand that was constructed by the petitioner with its own funds without outside aid.

The unsatisfactory results described above would all be avoided by following the legally sound and administratively necessary rule of disregarding the source of the funds expended on the construction of property in determining its cost.

II

EVEN IF THE CONSTRUCTION FUNDS COULD BE TRACED AND THEIR SOURCE WERE MATERIAL, PETITIONER'S BASIS FOR DEPRECIATION OF THE LINE EXTENSIONS UNDER THE STATUTE WOULD STILL BE THE AMOUNT EXPENDED ON THEIR CONSTRUCTION.

There is a basic dilemma here that the Commissioner cannot escape. Inevitably, the petitioner (a) acquired the line extensions for a consideration or (b) acquired them without a consideration. As we shall proceed to show, Congress has covered both contingencies in the statute, and it is immaterial to the petitioner which of the two premises is assumed to be the correct one. If the petitioner gave a consideration, then the amount of that consideration is the cost to it of the line extensions and its basis for depreciation. If it gave no consideration for the extensions on the theory that they were in effect contributed to it, then under the statute it takes over the line extensions at the transferors' basis, which was the cost thereof to them.

It is the petitioner's position, as hereinbefore pointed out, that it acquired the line extensions for a consideration consisting of the amount expended by it on their construction, and that the source of the construction funds even if traceable is immaterial in determining the cost of construction. If this is so, that cost is the depreciation basis. The applicants' contributions, though their status need not here be determined, stand on their own feet.

However, the Court below, insisting upon fixing the status of the contributions, ruled that the contributions were not gifts because supported by considerations, that

they were not contributions to capital or paid-in surplus because they were not made by shareholders and were for the specific purpose of constructing improvements but that, notwithstanding the presence of consideration, they constituted "receipts" which must be deducted under Section 113(b)(1)(A) of the statute in determining petitioner's cost. In so ruling, the Court was clearly in error.

(1)

The statute is of course controlling. Turning to the pertinent basis provisions of the 1936 Act set forth in the Appendix, we find that Section 114(a) provides that the basis upon which depreciation is to be allowed in respect of a property is the "adjusted basis" provided in Section 113(b) for the purpose of determining gain upon sale or other disposition of such property. Accordingly, if the line extensions have a basis to the petitioner for the purpose of determining gain on sale or exchange, they inevitably have the same basis for depreciation purposes as the Court below admitted; and, by denying petitioner any basis for depreciating them to the extent constructed with applicants' moneys, the Court below and the Commissioner place themselves in the paradoxical position of being forced to say that in the event of the sale of such extensions the entire proceeds would be income though the receipt of the money in the first instance, or indeed of the property itself if it had been directly contributed, was admittedly not income.[3]

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[3] In this connection, the status of railroad land grants may be noted. Such grants are not income (see pages 10, 11, 28 and 29 of this brief). It is well known that they have been commonly made not only to provide rights of way but to provide railroad capital through sale of donated lands adjacent thereto. To deny any basis for lands so sold would largely frustrate the purpose of the grants.

Since Section 114(a) directs us to Section 113(b) for the depreciation basis, we turn to this latter provision. It deals with "adjusted basis"; and, logically enough, it refers back to subdivision (a) of Section 113 for a definition of "basis (unadjusted)", for subdivision (b) merely supplies the adjustments to be made to the unadjusted basis, which must be first determined.

Subdivision (a) of Section 113 is the vital provision. It starts with the simple statement that the basis (unadjusted) of property shall be the cost of such property and then proceeds with a long list of carefully drawn exceptions, of which it is now important only to note that if property is acquired after 1920 by gift, or as paid-in surplus, or as a contribution to capital, then under exceptions (2) and (8)(B) the transferor's basis is to be used.

The statute recognizes the fundamental principle that depreciation sustained through use of exhaustible property in a business is an inevitable burden of doing business, and that profits cannot be determined until depreciation is taken into account.[4] It undertakes to cover in detail the whole field of allowances for depreciation and the depreciation basis, however the property may have been acquired. Congress was concerned with the fact that it is

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[4] The comment of the Court below, that allowance of depreciation deductions, like all deductions, is a matter of legislative grace, should not be passed unnoticed. Accrued depreciation, differing from other deductions, must be deducted in determining cost of property even though the statute is silent, because of its essential nature as a return of capital. *United States* v. *Ludey*, 274 U. S. 295. It is by no means clear that depreciation, similar to cost of goods sold (*Goodrich* v. *Edwards*, 255 U. S. 527; *Burnet* v. *Logan*, 283 U. S. 404), need not as a matter of constitutional law be taken into account in arriving at gross income. See Magill, Taxable Income, page 329.

the property itself that depreciates; and it provided for a continuity of the depreciation basis and gave a new basis only when an owner, paying a consideration, ought not to be tied to someone else's cost.

(2)

The Court below stated that the contributions "were supported by considerations", since the petitioner "obligated itself to build the facilities and the contributors expected to obtain full remuneration by use of the electric energy produced by the petitioner". Yet having found consideration the Court failed to recognize the value thereof in any way. At this point it may be well to quote from the decision of the Board of Tax Appeals in *Robinson* v. *Commissioner*, 35 B. T. A. 1080, affirmed 97 F. (2d) 552 (C. C. A. 9th):

> "The respondent argues that the transfer * * * was not a gift to petitioner, but was for a valuable consideration. At the same time he contends that they cost him nothing. We do not think these positions are consistent."

If the contributions and the subsequent construction of the line extensions out of petitioner's general working funds are not severable transactions standing on their own feet, the transactions obviously cannot reasonably be interpreted any differently than if the facilities had themselves been contributed in lieu of the equivalent in cash, as the petitioner's rules permitted. To say that the consideration for the contributions was the agreement to construct is to disregard substance; if it means anything at all it is that the contributions were bought with an obligation, fully performed, of at least equal worth. And of course the contributions cannot consistently be treated as receipts

serving to reduce basis under Section 113(b)(1)(A) if they were acquired for a consideration.

Conceivably, however, the Court could have found consideration. Disregarding its agreement to construct them, what did the petitioner give and the applicants for service get? In each case, the fundamental purpose of the deal was to bring about a situation whereby the petitioner would be legally obligated: (a) to sell electric energy at the usual regulated rates to the applicant and others who could be served from the line extension, and to serve them not only for the moment but continuously so long as they desired service or until the Michigan Public Service Commission should authorize abandonment of the line; and (b) to maintain the line extension and at the expiration of its useful life replace it, and again and again to repeat this process, all at the petitioner's own expense and regardless of profit therefrom, in order that the petitioner might live up to its continuous obligation to serve. These were the petitioner's resulting obligations: they would not have existed had not the particular line extension requested been constructed; they came into existence by virtue of the construction pursuant to the contract; and they were the very reason why the applicant entered into the contract and made the payment. Under well-settled principles of law, the petitioner's obligations thus arising might be considered implied terms of the contract. *Northern Pacific Railway Co.* v. *Wall*, 241 U. S. 87; *Guilford Lumber Manufacturing Co.* v. *Holladay*, 178 N. C. 417, 100 S. E. 597; *Wood* v. *Duff-Gordon*, 222 N. Y. 88, 118 N. E. 214; and 5 Williston, Contracts, § 1293, page 3683.

This being true, the case at bar is strikingly similar to *Robinson* v. *Commissioner, supra.* There the owner of a

public utility entered into contracts, with the approval of the Railroad Commission of California, whereby he received from the subdividers of certain land title to water mains, pipes and other connections, to be installed by the subdividers or at their expense, in consideration for which he agreed to maintain the property so received and to furnish at regular rates an adequate supply of water to consumers in the subdivision. The basic question in the case was the cost of the property to the public utility owner; and both the Board and the Court held that the value of his agreements, constituting his cost of the property, was the value of that property since it was given to him in return for his agreements in a transaction entered into between parties dealing at arm's length.

A similar finding could be made here. The petitioner's obligations were thought by the applicants to be worth what they gave. The line extensions were thought by the petitioner to be worth the obligations it incurred; the petitioner would not have undertaken these obligations without the payment. The Michigan Public Service Commission approved the arrangement. Since the parties were dealing at arm's length and the transactions were approved by the Commission, it could reasonably be presumed that there was a fair exchange, and that the value of the consideration given by each side corresponded. In this view, the consideration given by the petitioner for the line extensions, and accordingly their cost, would be equal to what it got in exchange, namely, the value of the line extensions, which was their cost of construction.[5]

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[5] The decisions in the *Robinson* case, which were ignored in the opinions below, were doubtless influenced by the fact that the contributions to the individual taxpayer were induced by busi-

(3)

The Commissioner attempted below to distinguish the *Robinson* case chiefly on the ground that under the contracts here in question the petitioner incurred no obligation in return for what it received, its only obligations being those arising by operation of law or expressed in subsequently executed contracts for the sale of electrical energy. If this view is correct in the light of this Court's recent decision in *Helvering* v. *American Dental Co.* decided March 1, 1943, it inevitably follows that there being no consideration the contributions occupy the status of gifts or, more properly, of contributions to capital required in order to equalize the burden among the new and old consumers. The situation would then be viewed as if the petitioner and the Michigan Public Service Commission had said to each applicant: "consumers generally should not be made to bear the expense of an unprofitable extension simply for the convenience of serving you. If you want to be in a position to demand service from the petitioner you must first make a gift to it or a contribution to its capital sufficient to cover the excess burden of undertaking to serve you."

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ness motives, and possibly also by the fact that a transferee corporation assumed the taxpayer's obligations (presumably at the taxpayer's basis) resulting in an earlier recovery of basis by him. The facts in the *Robinson* case were somewhat similiar to those in *Southern Power & Manufacturing Co.* v. *Commissioner*, 82 F. (2) 104 (C.C.A. 5th), cited below; but there the questions of gift or consideration were not even discussed, the issue being restricted to whether on the facts a tax-free reorganization, involving a carry-forward of basis, had occurred when utility property was transferred by promoters to a corporation in 1923. The case of *Kell* v. *Commissioner*, 88 F. (2d) 453 (C. C. A. 5th), also cited below, involved quite a different question; the case simply stands for the obvious proposition that outside donations in money and property received by a railroad corporation do not constitute part of the individual promoter's costs.

But this view leads us to the same result, for under Section 113(a)(2) and (8)(B) of the statute and Article 113(a)(8)-1 of the regulations, quoted in the Appendix, the transferor's basis follows property that is received after 1920 as a gift or as a contribution to capital.

In ruling that the contributions petitioner received were not gifts, the Court below was influenced by the existence of business motives. The contributors "expected to obtain full remuneration by use of the electric energy produced". Since the decision below, this Court in *Helvering* v. *American Dental Co., supra,* has held business motives not inconsistent with a gift. In that case the taxpayer's landlord and certain commercial creditors cancelled certain past due obligations. The Commissioner urged that the cancellations involved realization of income and not gifts since the creditors acted for purely business reasons in anticipation of future business and not for altruistic reasons or out of pure generosity; and the Board of Tax Appeals sustained him. The Circuit Court of Appeals for the Seventh Circuit, in reversing the Board and holding the cancellations gifts, said:

> "Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. There is no evidence that the creditors did that which they did not intend to do. The creditors' motives are immaterial."

This Court affirmed, saying:

> "The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing,

and sufficient to make the cancellation here gifts within the statute."

This reasoning applies with even greater force to contributions to capital. Capital contributions are commonly made in commercial transactions; and it is upon the provisions of the statute and regulations in this regard—Section 113(a)(8)(B) and Article 113(a)(8)-1—that petitioner more heavily relies. But the Court below thought that the contributions here did not constitute contributions to capital because being conditioned upon a specified use they did not become irrevocably devoted to the satisfaction of all petitioner's obligations and because they were not made by shareholders. The Court erred on both counts. Capital contributions, as in the case of gifts, may properly be made for specific purposes; the conditions imposed by the contributors were in no sense inconsistent with the vesting of full title and control in the petitioner. *Edson* v. *Lucas,* 40 F. (2d) 398, 405 (C. C. A. 8th). And clearly, as the Commissioner's regulations expressly recognize, capital contributions may properly be made by non-stockholders.

Article 113(a)(8)-1 of Regulations 94, promulgated under the Revenue Act of 1936, expressly provides that property may be received "from a shareholder as paid-in surplus, or from any person as a contribution to capital". This quoted language has been contained in the Treasury Regulations through successive reenactments of the statute continuously since 1934 and is still outstanding. Article 113(a)(8)-1 of Regulations 86, 94 and 101; Section 19.113(a)(8)-1 of Regulations 103. Identical language is contained in the recently issued Excess Profits Tax Regulations 109, Section 30.718-1, and in Bulletin "F" (Revised January, 1942) of the Internal Revenue Bureau. Accord-

ingly, this unambiguous provision of the regulations now has the force of law. *Helvering* v. *Wilshire Oil Co., Inc.*, 308 U. S. 90, and *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110. Yet the Circuit Court of Appeals ignored it and ruled that the payments made by petitioner's prospective customers could not constitute contributions to capital since they were not made by shareholders. (*Cf.* Alexander Tax News Letters, December 11 and 18, 1942.)

The above quoted regulation doubtless stems from just such cases as *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628. That case involved the taxability as income of money subsidies granted by the Cuban Government to a railroad company to promote construction of a railroad in Cuba and coincidentally to obtain reduced rates and other privileges. The subsidies were fixed and paid proportionately to mileage actually constructed and were used by the company for capital expenditures but were not used to reduce the actual cost of construction as carried on the books. In addition to the money subsidies the Cuban Government also contributed certain lands and other physical property in aid of completion of the railroad. The Treasury sought to tax the money but not the property. This Court, stating that the subsidies of neither kind were received as mere gratuities, held that they were not income and indicated that they were capital contributions, saying:

> "The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income."

There, as here, the subsidies were received from non-stockholders and for the specific purpose of constructing property. Yet this Court considered them capital contributions.

There, this Court thought that contributions in money and physical properties for similar specific purposes should be treated alike. Here, if the line extensions themselves had been contributed to petitioner in lieu of cash as petitioner's rules permitted, they obviously would have constituted capital contributions, not receipts serving to reduce the cost of any of petitioner's assets under Section 113(b)(1)(A). Yet the Court below would apparently distinguish between the treatment of cash and property contributions for the same purposes, since it has here applied Section 113(b)(1)(A) to the receipt of the cash.

(4)

Section 113(b)(1)(A) is not determinative of the issue here. To hold that it is, as did the Court below, is simply to beg the question, for the legal status of the contributions petitioner received would still be open for decision.

Section 113(b)(1)(A) merely contains the expected requirement that, in arriving at the "adjusted basis" of property, adjustment must be made to the "basis (unadjusted)" for items "properly chargeable to capital account". It relates only to subsequent capital items, for the very scheme of the statute calls first for a determination of "basis (unadjusted)", before Section 113(b)(1)(A) calling for adjustments thereto can come into play. In other words, the provision is an adjective not a subjective one, merely calling for subsequent adjustments if any should be made and not specifying what adjustments if any ought to be made.

Moreover, Section 113(b)(1)(A) contemplates adjustments both up and down. While, from a strictly accounting standpoint, to charge capital account commonly means to make capital account responsible, *i.e.*, to debit capital account, not to relieve it of responsibility by means of a credit (Webster's New International Dictionary, Standard Edition), the phrase "properly chargeable to capital account" as used in the statute was doubtless intended from its context to mean "properly attributable to capital account" and to encompass both debits and credits to capital account. Accordingly a subsequent capital "receipt" may increase or decrease "basis (unadjusted)", depending on its real nature. A receipt resulting from reduction of the purchase price of property, or from return against refund of unused construction material, or from reduction on final adjustment of the price paid a contractor for construction, or the like, calls for a decrease in capital account under Section 113(b)(1)(A). On the other hand, a receipt constituting a contribution to capital or a gift has exactly the opposite effect.

Thus it is entirely inaccurate to assume, as did the Court below, that "all receipts having some reasonable relationship to the asset, must be deducted from the cost". That the contributions here involved "had a direct relationship to the cost" of petitioner's facilities does indicate agreement that they are capital in nature, but the issue still remains whether or not they were gifts or capital contributions serving to increase, not decrease, capital account.

If an applicant builds a line extension and contributes it to petitioner in lieu of cash, can the contribution serve to reduce the basis of any of petitioner's property by adjustment of the unadjusted basis under Section 113(b)

(1)(A)? The question answers itself. The basis for petitioner's other property would not be affected. A single property contribution cannot create a basis and an adjustment of it as well. On the contrary, the line extension, if not deemed acquired for a consideration the value of which would establish its cost to the petitioner, would be a gift or a contribution to capital entitling petitioner under Section 113(a)(2) or (8)(B) to take over the extension at the contributor's cost.

This being so, if an applicant contributes funds exactly equivalent to the cost of an extension for the specific purpose of obtaining its construction, can the result be any different? Can it then be said that petitioner had a cost (*i.e.*, a "basis (unadjusted)") for the extension under Section 113(a) equal to the amount expended on its construction but that as a result of the antecedent contribution such cost is brought down to zero by subsequent adjustment under Section 113(b)(1)(A), whether or not the contribution is deemed received for a consideration?

If, as seems clear, the result under the scheme of the statute must be the same in both cases, can a distinction be drawn in the treatment of a contribution where under circumstances otherwise identical only half the cost of construction is contributed? Surely the answer must be no; and this demonstrates the fundamental error into which the Court below fell in its application of Section 113(b)(1)(A) to the contributions in the case at bar. This is true wholly apart from the Court's inconsistency in applying that basis adjustment provision to a receipt for which it found consideration had been given.

To summarize, Section 113(b)(1)(A) can have no different effect upon the basis of the line extensions here in

question than if they had been built by the prospective customers in the first instance and then turned over to the petitioner in lieu of cash, as the petitioner's rules expressly permitted. The correct view is that the cash contributions increased capital account, and when expended for capital assets served to increase the basis thereof, to exactly the same extent as if there had been a contribution of the property itself. In either case the basis for depreciation is the same under the scheme of the statute. For the contribution in either case is received under circumstances characterized by this Court in *Edwards* v. *Cuba Railroad Co.*, *supra*, as constituting a contribution to capital, and as such it comes squarely within Section 113(a)(8)(B) of the statute and Article 113(a)(8)-1 of the regulations.

Accordingly, Section 113(b)(1)(A) furnishes no aid in the solution of the issue here.

(5)

We thus come back to the inescapable fact that the line extensions were acquired by petitioner either for a consideration or without a consideration. If acquired for a consideration, the amount or value of that consideration is petitioner's cost and basis for depreciation under the general rule in Section 113(a) of the statute. If acquired without a consideration on the theory that they were in effect contributed by the prospective customers, then the petitioner took over the latter's basis under Section 113(a)(2) or (8)(B). Under either of these theories—alternatives covering the whole field—the result is the same: the petitioner's depreciation basis for the line extensions is what it cost to construct them.

This result is entirely sound, for if the petitioner is not allowed to deduct depreciation on this basis, then no

one will be entitled to the depreciation which the statute generally contemplates should be allowed to someone.

The Commissioner suggested below that a customer making a cash contribution may have a depreciable interest in the particular line extension, and argued therefrom that the petitioner ought not to be permitted to depreciate at the full cost since two taxpayers might then be depreciating the same thing. But so far as the petitioner is aware the Commissioner has not offered to allow customers such depreciation, and his regulations do not provide for it. His suggestion is in fact wholly without merit. It is clear that if a customer builds and owns a line extension in connection with his business, he, and he alone, is entitled to depreciation on it, no matter whence he derived the funds. The utility could not take depreciation, for it does not own the property and suffers no depreciation on it. Thus, in respect of poles furnished and owned by applicants in accordance with Exhibit V (R. 35-37), the petitioner is entitled to no depreciation; such poles are not included in the petitioner's property account or in the amount specified in paragraph (11) of the stipulation of facts. On the other hand, where as here the utility owns, controls and operates the line extension, it is entitled to depreciation on it and the customer can take no depreciation even though he contributed it or made a cash contribution to procure its construction. In such case, the customer has no legal or equitable title to or interest in or control over any particular extension. His only right is the legal right in common with all customers to take advantage of the public utility law which requires the recipient as a public utility to serve its customers and to continue to serve them, without limit as to time, once it undertakes to serve their territory, unless

and until the Public Service Commission permits otherwise. Such a right, representing no interest in or control over any particular line extension, continuing indefinitely through successive renewals and replacements of the original extension, and common to all customers, could not possibly be made the basis for depreciation. Under the statute the right to depreciation and the obligation to report gain on sale of an extension go hand in hand. Here the burden of reporting such profit would clearly rest upon the petitioner alone; and correspondingly it is entitled to the entire depreciation.

The Commissioner also countered below with cases, mostly involving leased property, which involved special situations wholly distinguishable and which involved no element of contribution to capital or gift. Of course a lessor, who suffers no depreciation because his lessee has covenanted to make it good, is entitled to no depreciation deduction. Of course a lessee is entitled to no depreciation deduction in respect of leased property which he neither constructs nor owns and for the use of which he pays a deductible rental. Of course a tenant constructing property on leased premises has a right to depreciate or amortize his cost of construction over the useful life of the structure or the term of the lease, whichever is shorter. Treasury Regulations 103, Section 19.23(a)-10. And of course a tenant who simply constructs property for the landlord on the leased premises at the landlord's expense, as in the second issue in *Nashville Warehouse & Elevator Corp.* v. *Commissioner, supra*, from which the Commissioner sought below to derive comfort, comes within the former and not the latter category. But all this has no bearing upon the general policy of the statute or upon the case at bar. Here,

contrary to the lease cases, the petitioner owns and operates the property and suffers depreciation on it; and the only question is the basis for depreciation under the statute.

Petitioner's position, we repeat, is in accordance with the terms and the spirit of the statute. If a taxpayer owns a plant, the statute authorizes deduction of depreciation on it whether it was acquired for a consideration or without a consideration. If the taxpayer built it or otherwise acquired it for a consideration, the depreciation basis is the amount or value of the consideration given for it by the taxpayer, which would be its cost; and this would be true irrespective of whether the money utilized for that purpose was derived from capital, earnings, borrowings, gifts, inheritance or any other source. If the taxpayer gave no consideration and accordingly received the plant as a gift or inheritance or as a contribution to capital or paid-in surplus, the depreciation basis would continue to be the same as in the hands of the transferor. The operation of the plant of necessity consumes it over its useful life, the owner thereby suffers a loss and hence depreciation is allowed.

III

ALLOWANCE OF THE DEPRECIATION HERE CLAIMED WOULD PRODUCE A WHOLLY FAIR AND REASONABLE RESULT.

Whether or not the depreciation here claimed by the petitioner ought in fairness to be allowed is basically irrelevant. The wisdom of the deduction is for Congress to decide; and if the statute and regulations provide for the depreciation it must be allowed whether or not the Courts

would have chosen otherwise. Cf. *Helvering* v. *Credit Alliance Corp.*, 316 U. S. 107. Cf. also *Helvering* v. *Sabine Transportation Co., Inc.*, decided March 1, 1943, in which this Court sustained as authorized by statute the allowance of a dividends paid credit both at the time of issuance of bonds to the issuer's stockholders and at the time of their payment.

However, since the Board's judgment was clouded by failure to understand the effect of the allowance of the claimed depreciation and by an erroneous assumption that a "double benefit" would result therefrom, and since the judgment of the Circuit Court of Appeals may have been similarly clouded, it seems appropriate in conclusion to address ourselves to that point. This calls for a review of the background out of which this case arose, a background which may have been overlooked.

As a public utility, petitioner is obliged to render service to all those who can be served from its distribution system, but not beyond; and its rates and practices generally are subject to the regulatory supervision of the Michigan Public Service Commission.

Requests for electric service by farmers and other prospective consumers located at remote points beyond the territory served by the petitioner's distribution system are from time to time received. The future energy requirements of such applicants for service are uncertain and may be limited. At the very least, the cost of constructing the necessary line extensions would make the cost of serving them greater than the cost of serving the consuming public generally.

What then should be done? The problem is of fundamental concern to the consuming public. The petitioner as

a public utility is always entitled to a reasonable profit; its profits cannot be excessive but it is entitled to charge rates that will not result in so low an overall profit as to be confiscatory. If customers in remote areas fail to pay their way, other customers must bear the burden. Each member of the consuming public has a vital interest in paying only a reasonable amount for the service rendered to him. He does not want, and in fairness should not be asked, to pay rates that are excessive in relation to the cost of the service rendered to him, simply to enable a few new customers in outlying districts to obtain service.

The best and most practical method of handling the situation in the interests of all concerned is the one sanctioned by the Michigan Public Service Commission and adopted by the petitioner here. The petitioner puts itself in a position to render service to such applicants by acquiring, maintaining and operating the necessary line extensions as part of its system. A uniform schedule of rates is adopted under which no distinction is drawn between the rates charged those served from the line extensions and the rates charged those served from the distribution system as a whole. An unfair burden on the balance of the consuming public is avoided by requiring applicants at their election either to build and contribute the extensions or to make cash contributions in aid of construction before the petitioner undertakes for their benefit to maintain and operate extensions that cannot earn their own way. And, in appropriate cases where the extent to which the extensions can earn their own way cannot be foreseen, the applicants are protected against overpayment by returning to them all or such part of their contributions as would appear at the expiration of a reasonable period to have been unnecessary.

This arrangement is fundamentally a fair one all around. The burden is fairly apportioned among consumers in accordance with the relative cost of serving them. The applicants, by contributing the extensions or cash, become entitled to obtain service at the regular uniform rates, a service which they would not otherwise be in a position to demand. The petitioner, being justified by the applicants' contributions includes the line extensions as a part of its regular system and becomes subject to all the responsibilities thereby entailed. It must continue to render service over the line extensions so long as any consumer demands service therefrom or until the Public Service Commission authorizes otherwise. It must maintain and repair the extensions in order that it may continue to render such service. It is liable for damage and injuries resulting from their operation. And at the expiration of their useful lives it must replace them in order to continue rendering service, without any opportunity at that time to obtain any further special contributions regardless of the cost of rendering the service.

The contributions made by applicants being designed to equalize the burden among consumers, the petitioner is not permitted to increase its overall earnings by virtue of the receipt thereof. They must either be deducted from assets in determining the rate base or the same result must be accomplished by taking the contributions currently into earnings for rate making purposes. *Re The Detroit Edison Co.*, 16 P. U. R. (N. S.) 59 (Michigan, 1936); *Re Harmony Electric Co.*, P. U. R. 1933A 306 (Michigan, 1932); *Re Northern Power Co.*, P. U. R. 1933C 128, 131 (Michigan, 1932). It is for this purpose that the segre-

gated accounts, Nos. 255 and 261 (described at R. 17-18), are utilized.

Although the petitioner's overall return must not include a return on applicants' contributions, the petitioner is required to depreciate the line extensions as in the case of its other property which has a limited useful life in order to build up a replacement fund that is necessary if a repetition of the same problem is to be avoided when the extensions must be replaced. Under the requirements of the Uniform System of Accounts adopted by the Michigan Public Service Commission, the depreciation on line extensions is handled through ordinary accounts in the regular way and is deducted in arriving at net earnings. It is credited to the depreciation reserve, and a balancing debit is made to Account 502, entitled "Depreciation", which is classified under operating revenue deductions and which is an operating expense. The entries are made in the same manner as though there had been no applicants' contributions.

This in general is the procedure. It is one that has been developed under the supervision of the Michigan Public Service Commission primarily in the interest of the consuming public, not the petitioner. Obviously the Commission would not countenance any arrangement that would give the petitioner something for nothing.

The Board thought that a "double benefit" would result if the petitioner were allowed both to receive the contributions without tax and to deduct depreciation on line extensions constructed with the aid thereof. But where in this is there any undue advantage or "double benefit"? As we have seen, the petitioner seeks the contributions and the Michigan Public Service Commission permits them to be received because the consuming public gen-

erally, to whom the burden would be passed on, should not bear the expense of unprofitable extensions for the convenience of one or a few persons. As a matter of fact, to the petitioner these contributions really result in no "benefit" at all, since they entail the commensurate responsibilities described above. Contributions of this character which are designed simply to apportion the consumer burden fairly, which may remain segregated long after the disappearance and replacement of the original line extensions, and upon which even after the original line extensions have gone the petitioner is not permitted to earn, have rightly been uniformly held not to constitute taxable income. On the other hand, the petitioner is under obligation to replace the extensions in order to continue to render service; hence if it were not allowed to build up a reserve through current depreciation it would be faced at the time of retirement with the very problem which the entire arrangement was intended to avoid. There is as much reason for providing for the rebuilding of the extensions as there is for the building of them in the first place, for the very basis of the original arrangement is that petitioner would be entitled to a continuance of the grant so long as its service obligations continued, without in effect being required to "buy" the extensions in order to carry out the obligations it undertook. The Michigan Commission, in common with other State Commissions,[6] recognizes this by denying the right to earn on the

[6] *Cf. Department of Public Service* v. *Grays Harbor Railway & Light Co.*, 12 P.U.R. (N.S.) 178, 197 (Washington, 1936); *Department of Public Service* v. *Pacific Power & Light Co.*, 13 P.U.R. (N.S.) 187, 204 (Washington, 1936); *Re Union & Jordan Irrigation Co.*, 30 P.U.R. (N.S.) 281, 287 (Utah, 1939); *Re Otter Tail Power Co.*, 33 P.U.R. (N.S.) 301 (North Dakota, 1940).

applicants' contributions but allowing deduction from current earnings of current depreciation so as to build up a reserve for rebuilding. While the governing revenue act does not make this a ground for allowance of depreciation for tax purposes, nevertheless the statute does by its terms authorize depreciation here. This being so, there is no occasion for straining to deny what the statute allows since allowance of depreciation for tax purposes, consistent with standard practice, would merely result in allowing the petitioner to accumulate a fund without tax thereon that is necessary to rebuild extensions which in the first instance were received without tax or were constructed with the aid of funds which it was permitted to receive without tax. If the contracts under which the extensions were built had required the applicants to pay the cost of rebuilding when their useful life was over and to put up security therefor, the petitioner would not need or be entitled to depreciation as it would get funds to rebuild, free of tax, just as it obtained the applicants' original contributions. But such contracts are impractical, and the same result can be accomplished so far as the petitioner is concerned only by the allowance of the depreciation it here claims.

Thus, the petitioner's position involves no doubling of advantages from the same thing. The only thing "double" about it is that the problem that arises when the line extensions are first built comes up again in connection with their replacement. A treatment concededly warranted when the problem first arises is equally as warranted when it recurs. The accumulation of funds without tax to replace the line extensions is as justifiable and proper as the receipt of applicants' contributions without tax concededly is in the first instance.

If when a line extension requires replacement the applicant were to make a new contribution to the petitioner, that contribution would be just as free from tax when received as the contribution made at the time of original construction—it is not a "double benefit" to be prohibited. The petitioner's position here is exactly the same, though the funds to rebuild come from depreciation instead of from the applicant. There is no "double benefit" in getting the funds to replace whether they come from either source.

Indeed, the petitioner gets no "benefit" therefrom at all. To call it such when there are commensurate burdens and responsibilities is a misnomer. But, waiving the misnomer, it is not in any sense a double benefit but at most a second benefit; replacement of the line extension simply requires a repetition of the benefit given at the time of the original installation.

Actually, however, it is not even a second benefit. The original grant is simply continued. For the original arrangement basically contemplated that the petitioner would be entitled to a continuance of the grant so long as its service obligations continued, without being required at any stage in effect to "buy" the line extensions in order to carry out the service obligations it originally incurred.

The petitioner's position on this point should not be misunderstood: it does not say that the foregoing considerations would of themselves give it the right to depreciation for tax purposes; but it does say that these considerations establish that there is no unfair advantage or "double benefit" that should deprive it of the allowance for depreciation given by the statute.

IV

CONCLUSION

Allowance of the depreciation deductions here claimed by the petitioner is plainly within the statute, is eminently fair, and should be approved. Accordingly the decision of the Court below should be reversed.

Respectfully submitted,

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APPENDIX

Pertinent Provisions of the Revenue Act of 1936, Ch. 690, 49 Stat. 1648.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

* * *

"(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * *

"(*n*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property."

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(*a*) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * *

"(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower.

* * *

"(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * *

"(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * *

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, * * *

* * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;"

Treasury Regulations 94, promulgated under the Revenue Act of 1936, provide with respect to Section 113(a)(8)(B):

"Art. 113(a)(8)-1. Property acquired by a corporation after December 31, 1920.— * *

"In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *"